Moody's Investors Service

Global Credit Research
Rating Update
22 MAY 2006

Rating Update: **California (State of)**

MOODY'S UPGRADES CALIFORNIA TO A1, BASED ON STRONG ECONOMIC AND TAX REVENUE TRENDS AND MODERATELY IMPROVED FISCAL OUTLOOK

Stable outlook applies to $48 billion of affected G.O. bonds and related debt

State
CA

Opinion

NEW YORK, May 22, 2006 -- Moody's Investors Service has upgraded the State of California's general obligation bonds to A1 from A2, and changed the rating outlook to stable from positive. The upgrade reflects the state's strong economic and tax revenue trends, better than expected financial performance in fiscal 2006, and a moderately improved financial outlook for 2007 and beyond. As discussed in more detail below, improvement in the fiscal outlook somewhat lags the state's revenue improvement due to its expansive education funding policies. California's rating still remains low compared to other states due to its ongoing fiscal challenges as well as constitutional and political constraints on its financial flexibility. The stable rating outlook at this time reflects the expectation that these relative weaknesses will persist and will not easily be overcome by further economic improvement.

Today's rating action affects some $38.3 billion of outstanding state G.O. bonds, $6.5 billion of General Fund-supported lease revenue bonds and judgment obligations, and $3.2 billion of General Fund-enhanced tobacco settlement bonds. The state also has $10 billion of outstanding Economic Recovery Bonds, which constitute state general obligations but are rated Aa3/stable (unchanged) based on additional security provided by a pledge of certain state sales tax revenues. The current rating action takes into account the large increase in long-term state debt that has occurred over recent years, which results in an above-average level of indebtedness relative to other states. State debt levels are expected to continue to rise in the future, but are expected to remain manageable in terms of annual servicing burden on the state budget.

STATE'S CREDIT IMPROVED DUE TO ECONOMIC AND TAX REVENUE TRENDS

California's economy recorded a strengthening pace of economic recovery during 2005, and the state's trend of economic expansion appears to be continuing into 2006 despite some early signs of slowing in the residential construction sector. Total payroll employment, for example, recorded average growth of 1.8% in 2005, with continued growth at a similar pace in the first four months of this year. Job growth in the private sector (representing about 85% of total employment) has been higher than in the government sector, noting that the latter has resumed moderate growth over the past year after a period of flat or declining job levels. In terms of personal income, the state recorded over 6% growth in 2005, following 6.6% growth in 2004. The state's personal income growth and private sector job growth both moderately outpaced the nation as a whole over the past year, including good growth in the previously lagging San Francisco Bay Area. The state's current forecast calls for employment growth continuing at 1.6% for the remainder of 2006, and personal income growth this year of 6.2%, both of which are not unreasonable in light of recent trends.

Both the governor's office and the independent Legislative Analyst's Office (LAO) have significantly increased their projections of state tax revenues in fiscal 2006 and fiscal 2007, reflecting strong growth in personal income tax (PIT) receipts in recent months. The fiscal 2006 forecast now anticipates total operating revenue growth of 12.5%, including close to 16% growth in PIT receipts. This brings the two-year PIT increase to almost 36%, fueled in part by growing capital gains and stock option income. On a combined basis, the revenue contribution from these sources in 2006 is preliminarily estimated by the state at $12.2 billion, about 90% higher than the contribution in 2004. By comparison, in their prior peak year of fiscal 2001, these revenue sources contributed $17.6 billion of revenue, including a significantly higher share coming from stock options.

If the state's current estimates are correct, the gain from stock options and capital gains would represent 44% of the state's total PIT increase over the past two years, and put them at 13% of total general fund revenue (compared to the fiscal 2001 peak of 25% of revenue). The state currently estimates that approximately $2 billion of this revenue could potentially be non-recurring, an assessment that Moody's does not believe is unreasonable given current economic trends. Over the same two-year period, the state's sales tax and corporate tax receipts are up by 14% and 52%, respectively, both healthy increases that reflect the state's fundamentally good economic performance.

PROPOSED 2007 BUDGET GREATLY INCREASES PROP 98 EDUCATION SPENDING, CONTINUES MODERATE STRUCTRAL IMBALANCE

The governor has recently revised his budget proposal for fiscal 2007, based on revised revenue estimates for fiscal 2006 and 2007 that suggest new budgetary resources of close to $7.5 billion. These are proposed to be allocated between an increase in the budget reserve, some one-time capital spending, prepayment of certain external and internal debts, and new recurring spending primarily in the areas of education and corrections. The result is that the 2007 general fund spending plan is increased to $101 billon, or $98 billion excluding the proposed debt prepayments. The recurring spending increase in 2007 vs. fiscal 2006 (after the allocation of an additional $2 billion for education spending to 2006) is just over 7%.

The budget includes a $4.65 billion (12.7%) general fund spending increase for Proposition 98 education programs compared to the originally enacted 2006 budget, no significant budget cuts in other areas, and no tax increases or deficit borrowing, features which should lead to a relatively smooth legislative approval process in this election year. The budget reserve of $2.2 billion is up from the Governor's January proposal, but still somewhat narrow at 2.3% of estimated revenue. The LAO has recommended increasing the reserve, and there is initial interest from legislature leaders in an increase of as much as $1 billion (substituting this for a portion of the governor's proposed $1.47 billion Recovery bond prepayment).

Excluding one-time debt prepayments, the 2007 budget proposal is structurally unbalanced by about $3.5 billion, or 3.7% of estimated revenue for the year. This represents a continuation of the trend of moderate improvement compared to prior estimates. The Department of Finance indicates that the structural imbalance is as low as $2.5 billion when adjusted for proposed one-time capital spending items in the budget. The structural shortfall is financed by carrying forward the fiscal 2006 ending balance.

STATE'S RATING REMAINS LOW DUE TO ONGOING FISCAL CHALLENGES

California's rating remains low compared to other states due to its ongoing fiscal challenges. The most immediate challenge is the state's stubborn structural budget gap. Although moderate in size on its face -- at less than 4% in the fiscal 2007 budget proposal -- the gap remains a concern for three reasons: (i) its persistence after several years of good economic performance; (ii) the state's still relatively narrow budget reserves; and (iii) the state's high degree of reliance on tax revenue from volatile sources such as corporate net income, capital gains, exercised stock options, and high-income taxpayers generally. Although the conditions do not appear to be in place for a sharp high-end income decline in the near-term, this represents a significant area of potential exposure for the state. Any significant revenue underperformance in the near-term would directly lead to a swelling of the structural imbalance and cause difficult budgeting challenges.

In addition, we note that the state has been unsuccessful in its recent attempts to modify the system of constitutional requirements and constraints that reduces its financial flexibility. It is also moving forward with significant bonding plans to address a backlog of deferred infrastructure investment, and faces increasing budgetary costs in coming years for employee pension and healthcare benefits (similar to most other states).

LONG-TERM DEBT BURDEN INCREASING, BUT REMAINS IN MODERATE RANGE

Based on large borrowings for both capital and deficit purposes, the state's net tax-supported debt has doubled over the past three years, and is now some $58 billion. However, at about 4.4% of aggregate personal income (ranking eleventh highest in Moody's last survey of the fifty states), the debt burden is not currently a credit concern. Scheduled annual General Fund debt service as a percent of General Fund revenue remains less than 4.5%, noting that this excludes debt service on recovery bonds and tobacco settlement bonds and the associated pledged sales tax and tobacco revenues. The debt service ratio inclusive of these is closer to 6%. Looking ahead, the state has about a $30 billion backlog of authorized but unissued G.O. debt, and there will be a massive $37.3 billion G.O. bond measure for infrastructure investment purposes on the November 2006 ballot. As such, the state's debt measures are likely to continue to increase moderately in the coming years, but also to remain manageable in terms of the annual servicing burden to the state. We note that the $10 billion Economic Recovery bonds are expected to be amortized relatively rapidly, which will help offset the rising level of G.O. bonds and related debt service.

The state's principal pension plans are relatively well-funded, due in part to provisions of state law that ensure annual employer contributions in line with actuarial requirements (noting that some of the actuarial assumptions have recently been loosened by CALPERS). June 2005 funding ratios -- i.e. actuarial value of assets to actuarially calculated liabilities -- for the CALPERS and CALSTRS plans are about 83% and 86%, respectively. The state also has large unfunded retiree healthcare obligations, though these have not yet been precisely quantified. The state currently budgets for these benefits on a pay-as-you-go basis, with about

$1 billion included for this purpose in the 2007 budget (about 1% of the budget). An actuarially-based method of funding would require a significantly higher share of the budget, and the LAO has recommended that the state consider phasing-in this higher cost over a multiple year period.

Outlook

California's rating outlook has been changed to stable from positive. While good economic and revenue trends are expected to continue, the state's financial outlook continues to be challenged by persistent structural budget imbalance and significant exposure to potential revenue volatility, as well as constitutional and political constraints on the state's fiscal flexibility and response capacity. The stable rating outlook at this time reflects the expectation that these fiscal weaknesses will persist and will not easily be overcome by further economic improvement.

What could change the rating up?

* Structural changes in the state's budget process and system of constitutional spending requirements and constraints.

* Significant additional economic and revenue growth, leading to structural budget surpluses and greatly increased reserves.

What could change the rating down?

* Significant revenue underperformance, leading to wider than anticipated budget gaps and deteriorating liquidity measures.

Analysts

Timothy Blake
Analyst
Public Finance Group
Moody's Investors Service

Emily Raimes
Backup Analyst
Public Finance Group
Moody's Investors Service

Robert A. Kurtter
Senior Credit Officer
Public Finance Group
Moody's Investors Service

Gail Sussman
Director
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653